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APPENDIX

UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

No. 7265

THE SMOOT SAND & GRAVEL CORPORATION, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

ON PETITION TO REVIEW THE DECISIONS OF
THE TAX COURT OF THE UNITED STATES.

(Argued October 17, 1956. Decided January 16, 1957.)

Before SOPER, FAHY, and SOBELOFF, Circuit Judges.

David R. Shelton for Petitioner, and David O. Walter, Attorney, Department of Justice, (Charles K. Rice, Assistant Attorney General, Lee A. Jackson and A. F. Prescott, Attorneys, Department of Justice, on brief) for Respondent.

SOBELOFF, Circuit Judge:

This is a petition for review of a decision of the Tax Court of the United States upholding an assessment made by the Commissioner of Internal Revenue against the Petitioner, the Smoot Sand and Gravel Corporation, for surtaxes under Section 102 (a) of the Internal Revenue Code

of 1939.[1] Liability rests upon the finding that the corporation was availed of in the years 1945-1950 for the purpose of preventing the imposition of surtax upon its sole stockholder, Columbia Sand and Gravel Company, Inc., and upon L. E. Smoot, owner of all the common stock of the latter company.

Despite high earnings, petitioner declared no dividend during the period 1945-1950 and, in fact, has declared none since 1932. The statute makes accumulation beyond reasonable needs determinative of the prohibited purpose (to prevent imposition of surtax) "unless the corporation by the clear preponderance of the evidence shall prove to the contrary." Sec. 102 (c). The Commissioner found that the corporation did permit the earnings and profits of the petitioner to accumulate beyond the reasonable needs of the business, instead of being divided or distributed, and assessed tax liability for the years in question as follows:

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[1] Section 102, Surtax on Corporations Improperly Accumulating Surplus. (a) *Imposition of Tax.* There shall be levied, collected, and paid for each taxable year (in addition to other taxes imposed by this chapter) upon the net income of every corporation (other than a personal holding company as defined in section 501 or a foreign personal holding company as defined in Supplement P) if such corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders or the shareholders of any other corporation, through the medium of permitting earnings or profits to accumulate instead of being divided or distributed, a surtax equal to the sum of the following:

27½ per centum of the amount of the undistributed section 102 net income not in excess of $100,000.00, plus

38½ per centum of the undistributed section 102 net income in excess of $100,000.00.

Year	Alleged Sec. 102 Net Income	Alleged Sec. 102 Surtax
1945	$ 208,223.94	$ 69,166.22
1946	237,476.03	80,428.27
1947	356,230.82	126,148.87
1948	319,777.10	112,114.18
1949	96,211.21	26,458.08
1950	124,915.35	37,092.41
	$1,342,834.45	$451,408.03

It is the petitioner's contention that the accumulation of earnings during the taxable years was justified to meet actual or potential needs of the business and that the needs were in fact even greater than its combined surplus and reserves for contingencies. These conflicting contentions present the central issue.

The petitioner's testimony took a wide range, bringing into review various phases of the petitioner's business, its history, its policies, its problems, and its plans. The Commissioner concedes that if dividends were withheld in order to maintain reserves not in excess of the reasonable needs of the business, then the penalties of Section 102 do not apply. On an issue that is essentially factual, the scope of our review is limited to determining whether there is substantial evidence to support the findings of the Tax Court (*Helvering* vs. *National Grocery Company*, 304 U.S. 282; *Helvering* vs. *Stock Yards Company*, 318 U.S. 693; *W. H. Gunlocke Chain Company* vs. *Commissioner*, Cir. 2, 145 Fed. (2d) 791) and whether the law was correctly applied.

It is not feasible nor would it be useful to repeat in detail the facts which have been fully set forth in the findings and opinion of the Tax Court, but as we proceed, we shall outline the evidence sufficiently to indicate the points in controversy.

The Smoot Sand and Gravel Corporation is engaged in the mining, dredging, and processing of sand and gravel in the District of Columbia, having been organized by L. E. Smoot in 1927 to take over the business begun by him more than a half century ago. The company enjoys a prominent position in the industry, having furnished materials for many of the large public and private construction jobs in the District of Columbia."

As shown in the above table, the five-year accumulation of earnings alleged to be beyond the reasonable needs of this business amounted to $1,342,834.45. On December 31, 1944, the beginning of the period under consideration, and on December 31, 1950, the end of the period, petitioner's books showed the following schedules of reserves for contingencies:[2]

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[2] The word "reserves" as used in legal and accounting documents is capable of different meanings. The word is used variously to indicate: (1) a fund of cash actually set aside to meet a designated purpose; (2) estimated valuations of assets at less than their book values, such as (a) reserves for bad debts (made in valuing accounts receivable), or (b) reserves for depreciation (set up in estimating reduction in value of depreciable assets); (3) estimated liabilities; or (4) earmarking surplus for certain corporate purposes, to show that the sum is not available for dividends until the purpose for which the reserve is created has been met. It was in this last sense that the word was used by petitioner when it created the schedule of reserves for contingencies.

Reserve for:	Dec. 31, 1944	Dec. 31, 1950
Accrued bond interest	$ 615,203.29	836,783.29
Contract bonds	250,000.00	250,000.00
Workmen's insurance	150,000.00	200,000.00
Public liability	100,000.00	200,000.00
Fire and tornado insurance	250,000.00	250,000.00
Sand and gravel replacement	100,000.00	100,000.00
Concrete mixing equipment	500,000.00	500,000.00
Columbia Company good will	293,521.65	293,521.65
1941 income tax	3,974.25	.....
1942 income tax	16,663.61	.....
New Southeast plant	500,000.00	500,000.00
Postwar rehabilitation	1,333,000.00	1,333,000.00
Postwar credit	26,134.38	.....
Federal income tax, 1944	109,112.96	.....
D. C. income tax	10,846.38	19,608.22
Replacement sand and gravel	2,578.05	.....
Total	$4,261,034.57	$4,482,913.16[3]

During this period, however, the petitioner had on hand a large surplus over and above the amounts which it had as reserves. At the beginning of 1945, the total of the reserves and surplus amounted to $6,197,061.88, and at the close of 1950 it had grown to $7,646,805.92. In considering the company's fiscal needs and determining the reasonableness of its accumulation of earnings, it is, of course, necessary to take into account the capital resources it had from time to time in addition to its reserves.

I.

In 1953, primarily for the purposes of this suit, petitioner, with the aid of the American Appraisal Company, made a reappraisal of its financial needs, repudiating and abandoning as inadequate the schedules theretofore appear-

[3] The taxpayer does not agree to the accuracy of the above figures for 1950, which are taken from the Court's findings. Taxpayer claims that the correct figure is $4,738,102.32, a difference of $255,189.16. The original exhibit (Petitioner's Exhibit 14) gives a total in accord with petitioner's claim. However, the figure there appears to result from error in adding the items.

ing on its books. Throughout these proceedings, petitioner has sought to justify the accumulation of earnings on the basis of this reappraisal, which purports to show that petitioner's true financial needs in 1945 were $13,662,573.11 and gradually increased to $15,809,513.33 by 1950.[4]

A large part of this reappraisal consists of allotments for future replacement of various assets used by petitioner in mining and processing sand and gravel, and for expansion of plants and equipment used in the business. Petitioner owns three plants and uses large and expensive machinery and equipment in its operations. During World War II the company was particularly active to the point of strain upon its facilities and claims that reserves were therefore required for rehabilitation. It cannot be disputed that corporate reserves may properly take such objectives into account. But formal entries upon the books do not alone substantiate such needs, nor is justification for such reserves to be found merely in subsequently declared intentions. The intention claimed must be manifested by some contemporaneous course of conduct directed toward the claimed purpose. *KOMA, Inc.* vs. *Commissioner*, Cir. 10, 189 Fed. 2d 390; *Bride* vs. *Commissioner*, Cir. 8, 224 Fed. 2d 39. Here the petitioner failed to show that it had during the period 1945-1950 any definite plan for future replacement and expansion out of reserves.

The petitioner complains that the Tax Court improperly ignored the entire testimony of petitioner's witnesses re-

[4] These figures are from the petitioner's brief; but in the Tax Court, petitioner quoted them as $12,939,406.38 and $15,293,233.16; and the Tax Court uses round figures as "over $13,500,000.00, and $15,500,000.00." The petitioner's brief and appendix abound in such discrepancies. The diffuseness of the record, the absence of adequate references thereto, and the necessity of following through the references to a series of petitioner's briefs, arguments, and proposed findings which were offered in the Tax Court and included in the record here, but none of which documents is the original source, have made more difficult the perception and appraisal of petitioner's contentions.

garding the evaluation of sums needed for rehabilitation, even though the Government presented no evidence to rebut these estimates. In this respect, however, the petitioner labors under an obvious misconception. Basically the Tax Court did not undertake to dispute the petitioner's evidence as to the amounts needed for replacement and expansion. These estimates may, indeed, have been correct. Rather, the Court's decision relied upon the fact that these alleged needs were not the considerations upon which petitioner's accumulations of earnings were made. In order to determine whether profits were accumulated for the reasonable needs of the business or to avoid the surtax upon shareholders, the controlling intention of the taxpayer is that which is manifested at the time of the accumulation, not subsequently declared intentions which are merely the products of afterthought. *KOMA* vs. *Commissioner*, supra; *Bride* vs. *Commissioner*, supra.

II.

The issue of inflation was vigorously argued before us. Although the evidence shows that petitioner did not formulate or initiate any program for expansion or substantial replacement during the period 1945-1950, it seeks to excuse such omission by saying that the progressive inflation of those years made such investment inadvisable, inasmuch as it was awaiting "the usual post-war deflation." Despite this explanation, the petitioner nevertheless insists that in computing its capital requirements, the inflation in prices which occurred during the period should be considered. The Tax Court, says the petitioner, committed error in failing to consider this factor. 'A large part of the record is devoted to the issue of economic trends, but we think the entire discussion irrelevant to this case. There is a basic inconsistency in the petitioner's position, for if petitioner expected deflation, and for that reason deferred making investments, then assuredly its reserves reasonably could not have taken into consideration the factor

of inflation. In effect, its contention is that although it was awaiting deflation before investing, it is entitled to have its reasonable needs computed, after the event, in an amount sufficient to meet inflationary increases in cost which were not anticipated even as a possibility when the reserves in question were created. Logically, its intentions in withholding distribution of earnings had to be based on one theory or the other; we think they could not rest on both. The taxpayer could not justify its failure to use the reserve on the ground that it expected prices to decline, and yet, in computing its capital requirements, ask us to measure them, not as it measured them at the time, but in the light of the subsequent inflationary rise in costs. We do not mean to intimate that inflationary economic trends may never be considered in calculating future corporate needs, and we are not called upon in this case to pass upon such a question. That the petitioner never considered such a factor in determining its needs and, indeed, anticipated just the opposite, is sufficient reason to uphold the Tax Court's failure to consider this contention.

III.

We are in agreement with the findings of the Tax Court regarding a certain other group of allocations of reserves, as these findings are supported by substantial evidence. These are the reserves for self-insurance, for contract bonds, and for the corporate bond indebtedness.

Since petitioner was a self-insurer, it allocated, in its schedule of reserves, amounts thought reasonably necessary to cover possible losses in respect to workmen's insurance, public liability, and tornado and fire damage, totaling $500,000.00 at the end of 1944, and $650,000.00 at the end of 1950. There can be no doubt that reserves for such contingencies are proper. While saving the premiums it would otherwise have had to pay, the petitioner assumed a direct liability in an undetermined amount, and

the reserve was an estimate of this contingent liability. If petitioner wished to prove that the amounts needed for those purposes were larger than its own books indicated, then as the Tax Court pointed out, it should have produced actuarial evidence to support its contention. Inasmuch as petitioner failed to do so, it was certainly not unreasonable for the Tax Court to hold that the petitioner should be held to the amounts which it had set up on its books and which reflected what petitioner currently conceived to be its potential liability in these areas. Indeed, there is an absence of substantial evidence in the record to support a finding that larger amounts were required.

In the Tax Court's opinion and in the arguments made by the parties in this Court, there was considerable discussion concerning the fact that such losses as occurred were met out of current income without charging the contingent reserves which had been set up. The Commissioner apparently suggests the inference that the reserve was, therefore, unnecessary. This seems to us not to follow. When a contingency reserve is established for a single, specific purpose (for example, to anticipate an adverse judgment in a pending law suit), clearly, should the judgment be recovered against the taxpayer and satisfied out of current operating expenses, the need for the reserve would cease. However, where a reserve is established against a continuing hazard, the fact that losses as they occur are satisfied out of current earnings does not necessarily require the abandonment or reduction of the reserve in that amount. On the contrary, the circumstances may justify increased reserves, if experience indicates that initial estimates are inadequate; and similarly, they may require a reduction of reserves for the opposite reason. Consequently, we conclude that charging such expenditures to operating expenses, without reducing the reserve, is not a condemning fact. We uphold the Tax Court's conclusion disallowing additional reserves for self insurance on the ground that the petitioner failed to present proper evidence

to indicate the need for reserves larger than appeared on its books.

Another item included in the schedule of contingent reserves was for "contract bonds." This reserve petitioner set up because it did not obtain performance bonds with respect to any of its job contracts. When a contractor engages to perform work, he is usually required to furnish a performance bond, but petitioner's business reputation was such that it was not called upon to furnish bond. Accordingly, it undertook to set up a reserve of $250,000.00. It is not clear against what contingency this reserve was provided. The fact that no bonding company guaranteed petitioner's performance did not increase the latter's liability which as contractor it would have had if bond had been furnished. The principal remains liable for the performance of his contract whether or not a bond has been furnished, and if the surety is called upon to make good a default the principal is liable to the surety. The contingency against which the petitioner ostensibly sought protection by means of a reserve was the kind of liability that every contractor has, in any event, for the performance of his contract. For this reserve, therefore, no justification appears.

Included in the schedule of contingent reserves in the company's books was an allocation for accrued bond interest, and petitioner claims that its reserves should include this as a financial need as well as the principal debt upon which the interest was calculated. Actually, the original schedule of reserves did not include the principal bond debt. The petitioner says, however, that the Tax Court has recognized but failed to give effect to it as a proper item of reserve. We do not read the Court's opinion as recognizing the propriety of a reserve for the bond principal and interest, nor could we agree that the evidence would have supported such a finding. The petitioner argued to the Tax Court the double contention, first that dividends

were out of the question because bond indebtedness exceeded net income for each of the years in question, and second that were it not for petitioner's poor financial situation, earnings would have been utilized to discharge the bond debt and not to pay dividends.

The Court properly rejected the first contention, pointing out that in a Section 102 inquiry, the proper test was a comparison of surplus with the reasonable needs of the business to determine the propriety of further accumulation of earnings, and not a comparison of the earnings in any one year with the outstanding corporate obligations. Regarding the second contention, the Court pointed out that petitioner's original capitalization consisted of $15,000.00 of capital stock and $3,000,000.00 in bonds owed to L. E. Smoot, a ratio of one to two-hundred, and that this ratio had been attacked in previous years by the Commissioner as a "thin capitalization," whereby the Commissioner sought to treat the bonds as capital stock and the interest as a dividend not deductible by petitioner. Though the cases were compromised and never adjudicated, the Tax Court here thought, in the light of these facts, that the petitioner's failure to discharge the bond debt was due not to any financial predicament of the petitioner, as claimed, but to its purpose to withhold payments in discharge of the debt for fear of again encountering an attempt on the Commissioner's part to treat such interest payments and reduction of bond principal as dividends. Furthermore, it was noted, payments could be postponed indefinitely at Mr. Smoot's discretion. In these circumstances, it is difficult to perceive any justification for creating a reserve for the bond indebtedness.

IV.

Both in the original schedule for reserves and in the subsequent 1953 reappraisal of needs, figures were set out representing the estimated cost of entering into the

ready-mix concrete business. The ready-mix concrete business had become the major part of the cement industry in Washington, as well as in the rest of the nation, and a large portion of the sand and gravel sales made by the petitioner was to ready-mix customers. Because of the powerful position attained by the ready-mix concerns, they had the ability to demand price concessions from producers such as petitioner by threatening to enter into competition with them in the sand and gravel business. The petitioner says that, therefore, throughout the five-year period under examination, the ready-mix industry presented a continuing threat to it, and that it became strategically important, in order to withstand the pressure from these customers, for the petitioner to be financially prepared at all times to enter the ready-mix business. The further argument is that it was important to the petitioner that its ready-mix customers should know that if unduly pressed for price concessions and threatened with competition in the sand and gravel business, petitioner might respond by entering into competition with its ready-mix customers. This had the practical effect of offsetting the threats and demands of those customers. Therefore, petitioner's financial needs in each of the five years, as estimated in the 1953 appraisal, included $5,500,000.00 against the contingency of its entering into the ready-mix concrete business. This large figure was computed for the trial; the company's books for 1945-1950 showed only a contingent reserve of $500,000.00 for this item.

The Tax Court, refusing to recognize that a reserve for such need was reasonable, stated that "petitioner never planned or intended to go into the ready-mix business of its own free will, and the contingency which might have forced it to do so never developed." We think this was an improper way to dispose of the issue and that the reason assigned is not responsive to the claim asserted by the petitioner. If it was reasonable to anticipate a need for the petitioner to expand its business operations into the

ready-mix field, it is immaterial that such expansion would not be voluntary. Nor is it a conclusive answer that the contingency never, in fact, arose to force petitioner to enter this new business area. These circumstances do not reach the issue. What is material is whether or not petitioner reasonably believed that it might be forced into the ready-mix business as a defensive measure, and whether it reasonably intended to enter such business when and if the imminence of the threat should demand it. The fact that such a step would be taken involuntarily would not make the need less compelling. If the petitioner reasonably feared the contingency it had the right to protect itself by providing a reserve for this purpose.

If an inquiry addressed to this point in the light of the foregoing discussion were resolved in favor of the petitioner the Court would then have to determine the sum which petitioner at the time believed necessary to effectuate the purpose, though obviously the Court need not have accepted petitioner's estimate of $5,500,000.00. Acceptance of the petitioner's estimate, or a figure approaching this amount, for all or for a portion of the years in question, would have substantially affected the petitioner's financial requirements and the Section 102 surtax.

The Court might have disagreed with the Petitioner that it had reasonable ground to feel such a threat, or it may well be that the threat disappeared and was reduced merely to a remote possibility. If so, then from that time forward, the continued maintenance of the reserve would not have been proper. But we cannot determine from the Tax Court's findings whether this is what occurred, for no findings were made on these specific points. There are statements in the record that petitioner at one time had engaged a stand-by salesman to handle orders for ready-mix equipment but that the crisis was averted. We cannot, however, determine whether avoiding the crisis merely reduced the imminence of the threat, postponing it tem-

porarily, or whether the threat substantially disappeared. Nor is it clear whether these events occurred prior to 1945, the first of the taxable years in question, or at some later date, in which case, even assuming that the threat thereupon ended, the tax result for a portion of the five-year period might have been considerably affected.

As a second reason for not recognizing petitioner's claimed need for retaining resources to finance its entry into the ready-mix concrete business, the Tax Court asserted that since petitioner's stock was owned by one person, "the money would still have been available to petitioner for such an emergency, even if distribution had been made." The authorities cited by the Tax Court are *Helvering* vs. *National Grocery Co.*, 304 U. S. 582, and *Helvering* vs. *Chicago Stock Yards Co.*, 318 U.S. 693, and particularly the following sentence from the *National Grocery Co. case*: "Since Kohl was the sole owner of the corporation, the business would have been as well protected against unexpected demands for capital, and assured of capital for the purpose of any possible expansion, by his personal ownership of the securities as by the corporation's owning them." The very next sentence, however, in the opinion of the Supreme Court in the *National Grocery Co. case* is: "Moreover, no conceivable expansion could have utilized so large a surplus."

The first of these cited sentences must be read in the context of the whole opinion, from which it is plain enough that even without it, the decision would have been the same. Furthermore, were the statement deemed the controlling rationale of the decision, it would be authority for denying all sole stockholder corporations the right ever to maintain accumulations even for reasonable needs. The test expressed by the statute would then be completely abandoned. This, however, has not been the understanding of the Commissioner or the Tax Court, and if it were, disallowance would be automatic and there would be no

point to the elaborate computations of reasonable needs which are found in the adjudicated cases.

Moreover, in an enlightening footnote, the Supreme Court pointed out that had the amount of $582,850.38, the accumulation of earnings in question, been distributed to the sole stockholder, he would have incurred additional surtax liability of only $90,744.56. *Helvering* vs. *National Grocery Co.*, *supra*, p. 292, footnote 9. This tax would have been less than sixteen percent of the amount distributed. In the instant case the alleged Section 102 income for the tax years 1945 to 1950, inclusive, totaled $1,342,834.45, which, if distributed, would have resulted, as the Tax Court noted, in additional surtax liabilities to Mr. Smoot of almost $1,200,000.00, or approximately eighty-nine percent.

Clearly, in the tax economy of the period covered by the instant case, it can hardly be said that a distribution after deduction of income taxes by a high surtax bracket taxpayer is "available" for reinvestment in the corporation.

In any event, all that Justice Brandeis said in the quotation was that a corporation may not accumulate surplus for "unexpected demands." This is true regardless of whether it is owned by a single stockholder or by a larger group. Unexpected demands and unanticipated emergencies are not the reasonable needs for which a corporation may provide under Section 102 and are not contended for by this taxpayer. However, a contingency is a reasonable need for which a business may provide, if the likelihood, not merely the remote possibility, of its occurrence reasonably appears to a prudent business firm.

Accordingly, we think the Tax Court should decide whether petitioner reasonably believed that it would likely be forced into the ready-mix business during any of the taxable years in question and, if so, what sum was needed therefor.

The measure of the capital needed for such a purpose would be the extent and degree to which petitioner intended to engage in ready-mix activities and not the cost required to enter the business on the same scale as some other particular ready-mix concerns. Further, the Court should have determined when, if at all, the threat terminated and became too remote a possibility to justify reserves or, alternatively, whether petitioner abandoned its intentions, although the threat persisted. These issues demanded resolution and are not satisfied by a finding that petitioner never intended to go into the ready-mix business of its own free will, or by a finding that the feared contingency never developed. Without determining the highly pertinent issues we have indicated, the Tax Court could not properly calculate petitioner's financial requirements, and the failure to make findings on these issues was error on its part.

It is not necessary for a corporation to create surplus reserves on its books to cover its future business needs, as the petitioner here did. The Statute imposes no such evidentiary requirement, nor is the mere book entry conclusive, in a Section 102 case, that the reserve is for a reasonably anticipated business need. Also, sufficient capital resources may be available regardless of any specific reserve on the books. The Tax Court may well give weight to the fact that only $500,000.00 was set up in this reserve and that this figure was not changed during the period covered by this case. Or the Court may conclude that the idea of going into the ready-mix business is not genuine, but merely a fictitious facade to cover an unreasonable accumulation of surplus; if so, it may disallow the item in its entirety.

V.

In the course of a hypothetical analysis of petitioner's claim that it needed $3,000,000.00 in working capital, including self-insurance reserves, the Tax Court treated $500,000.00 as adequate working capital for petitioner,

exclusive of self-insurance reserves. This determination was based upon the formula that "accumulation of funds to meet operation expenses for at least one year is reasonable," citing *J. L. Goodman Furniture Company*, 11 TC 530. It is apparently true, as petitioner claims, that the Tax Court, in applying this formula, used only those indirect expenses on petitioner's profit and loss statements, which did not include the cost of goods sold. Petitioner did, however, have direct expenses, such as wages, fuel, and supplies, which, on its operating statements, were included in the cost of goods sold. These costs ranged from $484,647.00 to $778,043.00 in the five years in question. Such expenses were not recognized by the Tax Court in applying its formula, and we cannot ascertain from the decision and opinion whether the exclusion of the direct operation costs was intentional or, as petitioner asserts, inadvertent.

In the *Goodman Furniture Company case*, the Tax Court did not limit the working capital requirements of the taxpayer in that case to an amount sufficient to meet one year's operating expenses. The Tax Court in that case included in the calculation of working capital, allowances for inventories, accounts receivable and, *in addition*, funds sufficient to meet one year's operating expenses; and furthermore, the Tax Court in that case was dealing with a retail installment merchant.

Obviously, the working capital formula cited by the Tax Court in the instant case was only part of the formula used in the *Goodman Furniture Company case*. Perhaps the Tax Court, in citing the formula, believed that in the instant case it need make no allowance for direct expenses making up cost of goods sold because of weight given to evidence presented at the trial. But we cannot determine this from the Tax Court's decision.

Of course, even the complete formula used in *Goodman* to determine working capital may not be applicable without discrimination in all cases. Working capital needs of

businesses vary, being dependent upon the nature of the business, its credit policies, the amounts of inventories and rate of turnover, the amount of accounts receivable and the collection rate thereof, the availability of credit to the business, and similar relevant factors.

In our view, the Tax Court should make a determination of petitioner's working capital needs based upon the foregoing considerations. A clear disclosure of the method by which the Court computed the working capital required would not only go a long way to dispose of the issues in the instant case but could be useful to the legal and accounting professions as a future guide.

VI.

The final contention of the petitioner is that the deficiency notices were void, because issued as a result of improper administrative procedures. It is asserted that the officials who signed the deficiency notices did not personally know the facts on which they acted, but accepted the recommendations of subordinates. The record provides ample basis for the Tax Court's finding that in determining the deficiency, subordinate officials made the necessary examination of petitioner's tax returns. The official authorized to sign the notices is not required to know all of the details of fact in each case, but he may act on the investigation and findings of those responsible to him. To hold otherwise would burden and impede the administration of the law beyond the hope of practical efficiency.

It is also argued that the notice contained no determination of what the resulting taxes would have been upon distribution of earnings to petitioner's sole stockholder, Columbia, and to the latter's sole stockholder, L. E. Smoot. This contention is likewise lacking in merit. Not only were all the facts pertaining to the tax returns of Mr. Smoot individually, as well as of the two corporations which he controlled, in the possession of the Commissioner's repre-

sentatives, but, as the Respondent points out, these facts had been the subject of intensive inquiry and repeated conferences between the taxpayer and the Commissioner. We agree with the Tax Court that the Commissioner's assertion of Section 102 surtax inferentially carried with it the determination that failure to distribute earnings resulted in tax savings to the stockholders. *J. M. Perry and Company, Inc.* vs. *Commissioner* (Cir. 9), 120 Fed. 2d 123.

The broad conclusions in the final paragraph of the Tax Court's decision as to the absence of reasonable need are based upon its step by step analysis of petitioner's claims. Inasmuch as we have shown that as to the issues of additional working capital and entry into the ready-mix business, the reasons assigned for disallowance are inadequate, the conclusions drawn do not follow. This is not to say that the Tax Court may not upon rehearing reach the same conclusions, but for proper reasons.

Accordingly, we affirm the Tax Court on all issues except as to the working capital (exclusive of self-insurance reserves) necessary in petitioner's business and as to the ready-mix business, and remand the case to the Tax Court for findings in those respects in accordance with the views expressed in this opinion.

Reversed and remanded.

IN THE UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

No. 7265

THE SMOOT SAND & GRAVEL CORPORATION, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

Order

Upon consideration of the Appellant's motion for rehearing and for modification of the Court's opinion, it is, this 4th day of March, 1957, by the United States Court of Appeals for the Fourth Judicial Circuit, ORDERED that footnote 4, to which the Petitioner's counsel objects as ascribing "opprobrium" to him (although we do not agree that it does), BE AND THE SAME IS HEREBY, deleted.

MORRIS A. SOPER
United States Circuit Judge
CHARLES FAHY
United States Circuit Judge
SIMON E. SOBELOFF
United States Circuit Judge

FILED

Mar 8 1957

R. M. F. WILLIAMS, JR.
Clerk

A true copy,

Teste:

RICHARD M. F. WILLIAMS, JR., *Clerk*,
U.S. Court of Appeals for the
Fourth Circuit

UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

No. 7886.

THE SMOOT SAND & GRAVEL CORPORATION, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

ON PETITION TO REVIEW THE DECISIONS OF THE TAX COURT OF THE UNITED STATES.

(Argued October 19, 1959. Decided January 11, 1960.)

Before SOBELOFF, Chief Judge, and SOPER and BOREMAN, Circuit Judges.

David R. Shelton for Petitioner, and David O. Walter, Attorney, Department of Justice, (Charles K. Rice, Assistant Attorney General; Lee A. Jackson and A. F. Prescott, Attorneys, Department of Justice, on brief) for Respondent.

SOBELOFF, Chief Judge:

This case, here for the second time, concerns the taxpayer's liability for the years 1945-1950 for surtaxes under

§ 102 of the Internal Revenue Code of 1939[1] by reason of the alleged accumulation of profits "for the purpose of preventing the imposition of the surtax" upon its sole shareholder, Columbia Sand & Gravel Company, Inc., and upon L. E. Smoot, owner of all the common stock of Columbia. The Tax Court having sustained the Commissioner's position in the first trial of the case, this court, on review, concluded its opinion as follows:

> "Accordingly, we affirm the Tax Court on all issues except as to the working capital (exclusive of self-insurance reserves) necessary in petitioner's business

---

[1] Section 102 provides, in relevant part, as follows:

> "SEC. 102. SURTAX ON CORPORATIONS IMPROPERLY ACCUMULATING SURPLUS.
>
> (a) [as amended by Sec. 103(d), Revenue Act of 1941, c. 412, 55 Stat. 687] *Imposition of Tax.* There shall be levied, collected, and paid for each taxable year (in addition to other taxes imposed by this chapter) upon the net income of every corporation (other than a personal holding company as defined in section 501 or a foreign personal holding company as defined in Supplement P) if such corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders or the shareholders of any other corporation, through the medium of permitting earnings or profits to accumulate instead of being divided or distributed, a surtax equal to the sum of the following:
>
> 27½ per centum of the amount of the undistributed section 102 net income not in excess of $100,000, plus
>
> 38½ per centum of the undistributed section 102 net income in excess of $100,000.
>
> • • • • • •
>
> (c) *Evidence Determinative of Purpose.*—The fact that the earnings or profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid surtax upon shareholders unless the corporation by the clear preponderance of the evidence shall prove to the contrary."
>
> • • • • •

and as to the ready-mix business, and remand the case to the Tax Court for findings in those respects in accordance with the views expressed in this opinion." *Smoot Sand & Gravel Corp.* v. *Commissioner*, 241 F.2d 197, 208 (1957), cert. den. 354 U. S. 922, reh. den. 354 U. S. 943.

After remand, the Tax Court took further evidence and again upheld the Commissioner's imposition of surtaxes under § 102.

The background of this controversy is fully set forth in the two memoranda of the Tax Court, T.C. Memo 1956-82 and T. C. Memo 1958-221, respectively, and in our earlier opinion at 241 F.2d 197. It would serve no useful purpose to repeat all the facts that have been developed in the course of the litigation, but as we proceed we shall outline the evidence relevant to the disposition of the present issues.

Three main questions are involved on this review:

I. Did taxpayer's officers *reasonably believe* that it was necessary to accumulate earnings and profits, since the taxpayer might have to enter the ready-mix concrete business?

II. How much working capital was needed by the taxpayer?

III. Upon whom is the burden of proof as to the asserted unreasonable accumulation of earnings and profits?

I

Did the taxpayer *reasonably believe* in the years 1945-1950 that it would likely be forced into the ready-mix concrete business, thus justifying an accumulation of earnings and profits for that purpose? The Tax Court has now found that the taxpayer never intended to enter the business; never formulated any definite plans for doing so; was not at any time during the years in question under any real

threat from its customers or its competitors which might reasonably have been regarded by petitioner's officers as likely to force taxpayer into the ready-mix business; that "if any such threat ever existed it did not extend beyond 1940 at the latest." In sum, the finding is that "petitioner's officers had no reasonable cause to consider petitioner's entry into the ready-mix business as more than a remote possibility, or to accumulate petitioner's earnings and profits for that purpose."

It is the taxpayer's initial contention that the Tax Court found in its favor on this issue at the first trial and changed this finding in the second although no further unfavorable evidence was adduced. Great emphasis is placed by the taxpayer on the following passage of the Tax Court's first memorandum opinion:

> "In the meantime, the ready-mix concerns began demanding certain price concessions and other concessions which petitioner was unable or unwilling to grant, and transferring as much of their business as possible to petitioner's competitors. By 1945 this situation had reached the point where, *in the opinion of petitioner's officers,* it constituted a severe threat to petitioner's business. Petitioner was confronted with the alternative of going into the ready-mix business itself or losing the major portion of its sand and gravel market." (Emphasis supplied.)

We believe, however, that the Tax Court explains this statement adequately in its second opinion, when it declares,

> "In our original findings of fact we found that in the opinion of petitioner's officers, the actions of the ready-mix concerns in the vicinity of petitioner's business posed a serious threat to the continuation of the business as operated by petitioner, and that petitioner might eventually be forced into the ready-mix business itself. This finding was based on the testimony

> of petitioner's officers as to their state of mind during the critical period, some 6 to 10 years previously. We did not find that any such threat to petitioner's business constituted a reasonable need for a cash reserve sufficient to equip the petitioner for entry into the ready-mix business on a competitive basis, or what would have been a reasonable amount for such a reserve."

Taxpayer's main contention on this issue appears to be that its officers sincerely believed that it would be forced into the ready-mix industry because "[f]rom 1940 on petitioner was under heavy attack from powerful financial forces seeking to destroy and take its business." Taxpayer's brief continues as follows:

> "Also, on the basis of its long and repeated experiences, petitioner knows that those seeking to take or destroy its business will stop at nothing and will resort to such tactics as attempts to have Mr. Smoot indicted under the anti-trust laws, attempts to have petitioner's business destroyed under the anti-trust laws, attempts to have petitioner's business destroyed under the penalty surtax provisions of the Internal Revenue Code, attempts to have its customers' bank credit cut off if they continue to be petitioner's customers, and so on."

Eloquent but unsupported assertions in the brief do not take the place of testimony or proof. The "powerful financial forces" (also referred to, in taxpayer's brief, as "powerful invading financial interests from outside of Washington") are not identified by petitioner, nor is there evidence in the record of any threats made or pressures brought to bear against petitioner in the 1945-1950 period. The taxpayer's unsubstantiated allegations do not require or even permit a finding that it entertained at the time a

reasonable belief that it would have to enter the ready-mix business.

In further support of its asserted "reasonable belief," taxpayer presses several other considerations. It declares that at the end of World War II it was in a seriously weakened condition since its inventory and productive facilities were exhausted to such a point that it could not satisfy all the orders of its customers. Taxpayer maintains that "[d]ue to its weakened condition petitioner's management felt strongly that it was in greater peril than ever before from the ready-mix concrete industry during the 1945-1950 period." The proposed inference of weakness does not necessarily follow, and there is nothing more than bare assertion to support it. That the Tax Court interpreted petitioner's situation in a different light is evident from its finding that ". . . petitioner was in a strong economic position with more demands on its production than it could meet . . ." We think that the Tax Court was certainly not without warrant in its conclusion that taxpayer's inability to supply the demands on its production is, in the circumstances of this case, evidence of a strong, not a weak, economic position. Strong or weak, it sheds no light on the issue of whether the corporation, willingly or unwillingly, anticipated going into the ready-mix business.

Next, petitioner insists that "[b]y 1945 substantially every major sand and gravel producer had been *forced* into the ready-mixed concrete business or *destroyed and absorbed* by that industry." (Emphasis supplied.) However, one of taxpayer's own witnesses, Vincent P. Ahearn, Executive Secretary of the National Sand and Gravel Association and the National Ready-Mixed Concrete Association, in explaining why the sand and gravel companies themselves have developed ready-mix concrete businesses, testified:

> "It is a logical development because the sand and gravel producer produces two of the ingredients—of

> the industry, the fine and the coarse aggregate. Furthermore, he has the necessary facilities—the yards, the hoists, and the draglines. In many cases he has the staff to help develop the business. He had to expand his industry and his equipment, but it was more logical for him to do it in nearly every case than it was for a newcomer to come into the field. . . ."

There is not a word here about sand and gravel producers being *forced* into the ready-mix business or else being *destroyed and absorbed*. It is undisputed that the corporation did not, voluntarily or involuntarily, enter this business at any time. The Tax Court did not exceed reasonable limits in concluding from all the testimony in the case that there was at the time no reasonable cause to consider petitioner's entry into this new enterprise more than a remote possibility.

Another circumstance cited by petitioner is that it "kept from $3,000,000 to $3,300,000 on deposit in the Riggs National Bank, without interest, in the hope that those seeking to destroy or take its business would be deterred." This is treated as strong proof of its contention; yet petitioner does not really tie in the deposit with the alleged reasonable belief that it would be forced to engage in the ready-mix business. The fact that it kept on hand a large balance of uninvested cash is entirely neutral in respect to the issue the Tax Court was called upon to decide. There may have been other reasons for maintaining this accumulation, such as the expectation of deflation felt by many at the close of the war. In our earlier opinion, we noted that petitioner claimed to be "awaiting 'the usual post-war deflation.'" 241 F.2d 197, 202 (4th Cir., 1957).[2]

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[2] It is also noteworthy that while the taxpayer claims to have retained over $3,000,000 in cash to impress competitors with its ability to enter the ready-mix business, its balance sheets during the years in question show a reserve of only $500,000 for the purchase of concrete mixing equipment. See n. 4 *infra*.

Finally, taxpayer points to the Tax Court's decision in *Breitfeller Sales, Inc.*, 28 T.C. 1164 (1957), as contrary to its holding here. On the facts of that case the taxpayer, an automobile dealer, was held justified in accumulating earnings because of the "possibility that it might be required to finance a new dealership . . ." It should be observed that a "contemplated" expansion must be shown to have been a real consideration during the taxable year, and not simply an afterthought to justify challenged accumulations of surplus. *Helvering* v. *National Grocery Co.*, 304 U. S. 282 (1938); *Hedberg-Friedheim Cont. Co.* v. *Commissioner*, 251 F.2d 839 (8th Cir., 1958). The finding in *Breitfeller* was that the taxpayer's directors, during the years in issue, "reviewed and approved plans and policies for expanding facilities, making provision for protection of petitioner's 'interest' in the St. Albans area, and the possible financing of installment sales of automobiles." 28 T. C. 1164, 1167. In the case at bar, however, there was no such evidence and no such finding; on the contrary, what the Tax Court did find was that the petitioner never intended to enter the ready-mix business and never formulated definite plans for doing so.

II

How much working capital was needed by the taxpayer in the years from 1945 to 1950? In our earlier opinion, we said that:

> "Working capital needs of businesses vary, being dependent upon the nature of the business, its credit policies, the amount of inventories and rate of turnover, the amount of accounts receivable and the collection rate thereof, the availability of credit to the business, and similar relevant factors.
>
> In our view, the Tax Court should make a determination of petitioner's working capital needs based

upon the foregoing considerations. . . ." 241 F. 2d 197, 207 (4th Cir., 1957).

The Tax Court has now found that most of petitioner's sales during the years in question were for cash, payable within 30 to 60 days; that the average inventory turnover period was less than 4 days; that the average closing inventory of sand and gravel, at the end of each year, that is "Finished Goods," was not over $5,000.00; that the "Raw Materials" inventory was even less; that credit was readily available to petitioner; that the nature of the operations was such as to require a working capital reserve "for very much less than a full year"; and that, in conclusion, considering the above factors, as well as petitioner's direct and indirect expenses and cost of goods sold, "petitioner's working capital requirements would not have been in excess of between about $200,000 and $350,000 at any given time for the years under consideration." Petitioner's need for working capital for each of the taxable years was estimated by the court as follows:

Year	Reasonable Working Capital
1945	$201,997.45
1946	191,693.94
1947	197,557.52
1948	248,191.08
1949	351,667.37
1950	333,826.67

The Tax Court then turned to a broader consideration of the petitioner's financial situation in the relevant years. After an analysis of stipulated balance sheets taken from income tax returns, and in light of the other evidence, the court concluded that the Commissioner's imposition of surtaxes for unreasonable accumulations of surplus was proper. Its computation follows:

	12/31/45	12/31/46	12/31/47
Reserves per books	$4,298,728.25	$4,347,084.39	$4,464,566.42
Surplus not "Earmarked"	2,088,596.99	2,276,848.46	2,543,351.52
Total surplus	$6,387,325.24	$6,623,932.85	$7,007,917.94
Less:			
Reserves accepted as reasonable	$4,298,728.25	$4,347,084.39	$4,464,566.42
Loans to customers	72,917.00	.....	125,000.00
Working capital	500,000.00	500,000.00	500,000.00
Unreasonable accumulation	$1,515,679.99	$1,776,848.46	$1,908,351.52

	12/31/48	12/31/49	12/31/50
Reserve per books	$4,623,732.11	$4,566,666.38	$4,738,103.32
Surplus not "Earmarked"	2,618,292.96	2,697,915.75	2,908,702.60
Total surplus	$7,242,025.07	$7,264,582.13	$7,646,805.92
Less:			
Reserves accepted as reasonable	$4,623,732.11	$4,566,666.38	$4,738,103.32
Loans to customers	150,000.00	.....	92,505.00
Working capital	500,000.00	500,000.00	500,000.00
Unreasonable accumulation	$1,968,292.96	$2,197,915.75	$2,316,197.60

After this preliminary examination of the Tax Court's findings we look more closely at the applicable statutory provisions. Section 102 (a) provides that a surtax shall be imposed on corporations which are formed or availed of for the purpose of avoiding the surtax on its shareholders by permitting earnings and profits to accumulate instead of being distributed to the shareholders. Section 102 (c) provides that the fact that earnings and profits are permitted to accumulate beyond the *reasonable needs* of the business is *determinative* of the purpose to avoid surtax upon shareholders unless the corporation proves the contrary by the clear preponderance of the evidence. Thus, the size of the accumulated earnings and profits or surplus is not the crucial factor; rather, it is the reasonableness and nature of the surplus. Part of the surplus may be justifiably earmarked in the form of reserves, for specific, necessary business needs.[3] Again, to the extent the surplus has been

[3] In this connection, we think it appropriate to reiterate what was said in our earlier opinion in this case:

> "It is not necessary for a corporation to create surplus reserves on its books to cover its future business needs, as the petitioner here did. The statute imposes no such evidentiary

translated into plant expansion, increased receivables, enlarged inventories, or other assets related to its business, the corporation may accumulate surplus with impunity. Lasser and Holzman, *Corporate Accumulations and Section 102*, 93 (1949) and cases cited therein. Where, on the other hand, the accumulation of surplus is reflected in liquid assets in excess of the immediate or reasonably foreseeable business needs of the corporation, there is a strong indication that the purpose of the accumulation is to prevent the imposition of income taxes upon dividends which would have been distributed to the shareholders. Hall, "The Taxation of Corporate Surplus Accumulations," Joint Committee on the Economic Report, 82nd Cong., 2nd sess., quoted in Bittker, *Federal Income, Estate, and Gift Taxation* (2nd ed., 1948), 487; see also Mertens, *Law of Federal Income Taxation*, §39.51 (1956) and cases cited therein.

The ultimate question whether a corporation is availed of for the purpose of avoiding surtax on shareholders is one of fact. Unless the finding of the Tax Court is clearly erroneous, it should not be disturbed by the Court of Appeals. 26 U.S.C.A. Sec. 7482(a); *Casey* v. *Commissioner*, 267 F.2d 26 (2nd Cir., 1959); *Pelton Steel Casting Co.* v. *Commissioner*, 251 F.2d 278 (7th Cir., 1958). In order to determine whether the Tax Court's conclusions are clearly erroneous, we shall review the petitioner's financial condition for these years. In so doing, we shall address ourselves directly to the petitioner's contention that the Tax Court made the "astonishing mistake" of failing to grant allowances for the amounts specifically found by the Tax Court in its first opinion as properly allowable as reserves for (1) bad debts, (2) depreciation, (3) depletion, and (4) tax liabilities, allegedly ranging from $2,898,337.12 to $4,276,070.98 during the 1945-1950 period.

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requirement, nor is the mere book entry conclusive, in a Section 102 case, that the reserve is for a reasonably anticipated business need." 241 F. 2d 197, 207 (4th Cir., 1957).

Appended are the balance sheets for each of the tax years in question, and we examine the figures for 1945 as fairly illustrative.[4] It will be seen that the reserves earmarked out of surplus total $4,298,728.25; the surplus not earmarked is $2,088,596.99; the total surplus is thus $6,387,325.24. Of this sum, the Tax Court accepted as reasonable all the reserves earmarked on the balance sheet.[5] Taxpayer now asserts that the reserves accepted by the Tax Court are insufficient and that additional allowances should have been made to cover *bad debts, depreciation and depletion.*

A reserve for *bad debts*, or allowance for doubtful accounts represents an estimate of the amount of the accounts and notes receivable which will be uncollectible. The purpose of the reserve is (1) to charge the loss against the period in which it was actually incurred as a result of the sale of goods to customers whose accounts subsequently prove to be uncollectible and (2) to show the estimated realizable value of the customers' accounts. Finney & Miller, *Principles of Accounting—Intermediate*, 207 (5th ed., 1958). A taxpayer using the reserve method is allowed, under the Internal Revenue Code,[6] to charge off this estimated amount as an expense of its current operations. The appropriate accounting entry is to debit or charge an account called "bad debt expense" and to credit an account called "reserve for bad debts." The amount charged to bad debt expense is deducted by the taxpayer in computing his annual profit or loss. Therefore, this reduces net income for the year and likewise reduces the surplus account of the business. On the balance sheet, accounts receivable and notes receivable are shown *net* of the reserve for bad debts, and only the net figure is deemed to show the value of the

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[4] See Appendix.

[5] See n. 3 *supra*.

[6] Internal Revenue Code of 1939, Section 23 (k)(1); Internal Revenue Code of 1954, Section 166 (c).

receivables. The taxpayer is thus totally incorrect when it claims additional reserves for bad debts, because the bad debt expense has already been eliminated from surplus; moreover, only the *net* receivables were considered by the court in evaluating the taxpayer's assets which are available for dividends.

For the same reasons, the taxpayer's argument concerning the reserves for *depreciation and depletion* cannot be accepted. Surplus has already been reduced by annual charges to depreciation expense and to depletion expense; allowing them again would give the taxpayer double deductions. We are cognizant of the fact that replacement of taxpayer's wasting assets will ultimately become necessary, and that for this purpose cash or other liquid assets must be available; but, as will appear, taxpayer had much more liquidity than necessary for such replacement and for all other reasonable business needs.

Likewise, petitioner complains that it was denied a reserve for additional *income tax liabilities asserted* by the Commissioner in the following *alleged* amounts:

1945	$ 723,166.73
1946	1,155,907.50
1947	1,717,317.99
1948	1,794,562.00
1949	434,803.71
1950	516,275.17

It is undisputed that in 1946 a notice of deficiency was sent to taxpayer asserting deficiencies in income and excess profit taxes for the years 1940 to 1944 in the total amount of $922,619.84. At the same time, deficiencies were asserted against Columbia Sand & Gravel Company, Inc., and L. E. Smoot, individually. The claims against all three were settled in 1949. The taxpayer's deficiencies were determined to be $301,512.06 and were paid in 1949 and 1950.

The amounts of the deficiencies which the taxpayer alleges were asserted against it are nowhere proved, except

as to the $922,619.84. It should be observed that on the petitioner's balance sheets, a reserve for federal income tax appears for each of the years in question, but in much smaller amounts than are now alleged. Petitioner declares that its income tax liability, in the amounts stated above, was specifically found by the Tax Court in its first opinion. This is a bold claim in light of what the Tax Court actually said:

> "The additional tax liabilities determined against the petitioner for the years 1940 to 1944, inclusive, which were outstanding at the close of the years 1945 to 1950, inclusive rose from less than $1,000,000 in 1945 to a peak in 1948 of $1,794,562, including interest. We recognize, of course that petitioner was entitled to maintain a cash reserve sufficient to pay any tax liabilities which had been determined against it, except perhaps section 102 tax. At the same time, however, it is perfectly obvious that petitioner at all times during the 1945-1950 period had sufficient ready capital on hand over and above all asserted needs.
>
> A word may perhaps be appropriate as to the size of the tax liabilities claimed by petitioner to have existed in the taxable years. *Petitioner adds to its own deficiencies those determined against Columbia, its sole stockholder, and Smoot, Columbia's sole stockholder.* But while petitioner may have been entitled to retain funds for the payment of its own indebtedness, we think it clear that no supposed liabilities involving its immediate and remote stockholders, could be characterized as a need of its business. A distribution of its profits would have put those stockholders in funds so that they in turn could meet whatever tax liabilities might ultimately be imposed." (Emphasis supplied.)

Even if we assume that the taxpayer was entitled to an allowance of some part of the amount it claims, in excess of the allowances made, as a reserve for tax liability, the failure to grant this would not change the result in this

case, since all *proper* allowances would still be insufficient to account for the accumulations of surplus.

In its analysis of petitioner's financial condition the Tax Court accepted as reasonable all the reserves listed on the balance sheets, stating that "although in some cases the items included are doubtful as to character or amount, the benefit of that doubt has been extended in petitioner's favor." The court added that:

> "... as to a number of items on which the amount of the reserve was virtually the only evidence of a reasonable figure for the business needs, we may have fallen into error in viewing them as a proper measure of reasonable accumulations. Such items are, for example, $500,000 for ready-mix as originally allowed although it now appears that this allowance is overgenerous, reserves for Federal income taxes and contract bonds. Since, however, we regard these issues as no longer open upon the remand, we have retained the original figures in our summary."

We can understand the court's impression that the issue as to several of the reserves was no longer open upon the remand. However, we agree that the court was, to use its own word, "overgenerous" in the second proceeding, since it allowed (1) $500,000 for the purchase of concrete mixing equipment, in spite of its specific finding that the taxpayer did not need to accumulate any amounts whatever for this purpose, (2) $500,000 for working capital, although the court found taxpayer's needs to be less than this, (3) $250,000 for contract bonds, although this court held, in its earlier opinion, that no justification appears for this reserve.[7] Furthermore, it should be noted that in our earlier opinion, we concluded that in the existing circumstances, "it is difficult to perceive any justification for creating a reserve for bond indebtedness," i.e., accrued interest on the corporation's bonds held by Mr. Smoot individually.

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[7] 241 F. 2d 197, 203-204 (4th Cir., 1957).

241 F.2d 197, 204 (4th Cir., 1957). Finally, we have considerable doubt about the allowance of the large reserve in the sum of $1,333,000 for post war rehabilitation, which apparently merely involves future replacement of depreciated and depleted assets. We have previously noted that depreciation and depletion charges are deducted from surplus during the useful life of assets. Replacement of assets which are fully depreciated or depleted requires available cash but does not require a second appropriation of surplus. It is only when rehabilitation plans involve replacement of old equipment with equipment costing more than the original, or when additional equipment is required, that appropriation of surplus is justified. As stated in our earlier opinion, the taxpayer was not expecting inflation but deflation. None of the possible justifications for additional replacement reserves has been shown. On balance, it is clear enough that, however viewed, the allowances made by the Tax Court exceed any amount the taxpayer could possibly justify as reasonable reserves.

Having examined the reserves needed by the business, we turn to the amount of liquid assets available to meet these needs. In 1945, taxpayer had the following liquid assets:

Cash	$2,950,115.64
Net notes and accounts receivable	94,063.36
Inventories	47,619.01
Investments:	
Obligations for U.S., State, etc.	1,324,531.72
Other securities	7,922.34
Net loans secured and unsecured	1,091,628.89
	$5,515,880.96

Its only current liability was Accounts Payable, $1,092.59. Thus, petitioner had liquid assets of more than $5,500,000, much in excess of what was reasonably required in the business (even after taking into consideration amounts necessary to replace depreciated and depleted property).

Analysis of the other years in issue discloses a similar picture and leads to the same conclusion of unreasonable accumulations.

Viewed in broader context, the corporation's record of earnings and dividends over the years is also quite revealing. In every year since 1927 taxpayer has had net earnings in amounts ranging from approximately $200,000 to over $1,000,000. Twice only in this period has it declared dividends, $20,000 in 1928 and $800,000 in 1932. In the latter year, when L. E. Smoot reported the dividends of $800,000 in his individual income tax return, he had offsetting loss deductions of over $600,000. No other dividends have ever been paid, and the company's surplus has been permitted to swell.

The Tax Court's conclusion, far from being clearly erroneous, seems to be clearly correct.

III

On the question of burden of proof the Tax Court decided that, in the circumstances of this case, the burden of proof rests with the taxpayer, notwithstanding Sec. 534 of the Internal Revenue Code of 1954, 26 U.S.C.A., Sec. 534.[8] We need not decide the point here since, even assuming that the burden of proof was on the Government, we are convinced, as was the Tax Court, that this burden has been met by affirmative proof of "a deliberate, consistent and inescapable intention to retain its net earnings for the purpose of avoiding the surtax upon its immediate and ultimate stockholders."

The decisions of the Tax Court are

Affirmed.

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[8] Section 534 of the 1954 Code provides that the burden of proof shall be shifted to the Government if, after receiving notification from the Secretary or his delegate of an intention to assert a deficiency on the basis of unreasonable accumulation of earnings, the taxpayer submits a statement of the grounds (together with facts sufficient to show the basis thereof) on which it relies to escape the tax on all or any part of the earnings and profits by establishing the accumulations have been reasonable.

APPENDIX

THE SMOOT SAND & GRAVEL CORPORATION (DELAWARE)

Balance Sheets Taken from Income Tax Returns
1945 through 1950

	Dec. 31, 1945	Dec. 31, 1946	Dec. 31, 1947	Dec. 31, 1948	Dec. 31, 1949	Dec. 31, 1950
Cash	$2,950,115.64	$3,209,133.31	$3,311,060.72	$2,971,795.84	$3,213,854.38	$3,332,387.37
Notes & Accounts Receivable	106,563.36	179,721.60	192,233.13	211,176.94	24,786.03	206,071.60
Less Reserve	12,500.00	12,500.00	12,500.00	12,500.00	12,500.00	12,500.00
Net notes & accounts receivable	94,063.36	167,221.60	179,733.13	198,676.94	12,286.03	193,571.60
Inventories	47,619.01	65,765.87	65,719.43	74,390.15	64,950.23	59,929.91
Investments:						
Obligations of U. S., State, etc.	1,324,531.72	1,344,756.72	1,268,756.72	1,261,256.72	1,253,756.72	1,200,425.00
Other Securities	7,922.34	7,822.34	7,822.34	7,822.34	7,822.34	7,522.34
Leases						
Loans secured & Unsecured	1,212,920.99	1,144,166.39	1,432,971.09	1,924,048.23	1,811,843.23	1,852,786.52
Less Reserve	121,292.10	114,416.64	143,297.11	192,404.82	181,134.32	185,278.65
Net loans secured & Unsecured	1,091,628.89	1,029,749.75	1,289,673.98	1,731,643.41	1,630,208.91	1,667,507.87
Land	418,816.49	417,820.20	417,820.20	414,820.20	415,020.20	411,847.67
Buildings	359,644.46	359,644.46	359,644.46	347,818.96	347,818.96	350,255.20
Machinery & Equipment	1,925,790.78	1,932,612.32	2,094,430.16	2,293,959.12	2,479,370.34	2,535,444.91
Furniture & Fixtures	8,671.46	8,671.46	9,130.39	12,686.95	12,686.95	12,686.95
Total depreciable assets	2,294,106.70	2,300,928.24	2,463,205.01	2,654,465.03	2,839,876.25	2,898,387.06
Less Reserve	1,692,693.13	1,769,730.39	1,846,400.08	1,924,507.00	2,013,792.83	1,994,733.87
Net depreciable assets	601,413.57	531,197.85	616,804.93	729,958.03	826,083.42	903,653.19
Dredging rights	522,425.17	522,425.17	522,465.17	526,990.17	521,962.87	521,962.88
Less Reserve	348,685.16	348,685.16	348,685.16	352,097.16	359,054.16	363,685.16
	173,740.01	173,740.01	173,780.01	174,893.01	162,908.71	158,277.72
Goodwill Columbia Sand & Gravel Co.	293,521.65	293,521.65	293,521.65	293,521.65	293,521.65	293,521.65
Prepaid Insurance	545.15	149.80	.....	.....	.....	.....
Deposit (new scows)	.....	.....	.....	.....	.....	43,235.21
Total Assets	$7,003,917.83	$7,240,879.10	$7,624,693.11	$7,858,778.29	$7,880,412.59	$8,271,879.53

Liabilities & Capital						
Accounts Payable	$ 1,092.59	$ 1,446.25	$ 1,275.17	[redacted].22	$ 330.46	$ 9,573.61
Bonds & Notes	615,500.00	615,500.00	615,400.00	[redacted].00	615,500.00	615,500.00
Reserve for insurance replacements & contingencies; Replacement reserve Sand & Gravel	4,298,728.25	4,347,084.39	4,464,566.42	4,623,732.11	4,566,666.38	4,738,103.32
Capital Stock (300 Com. Sh. of no par value)	.....	.....	.....	.....	.....	.....
Surplus	2,088,596.99	2,276,848.46	2,543,351.52	2,618,292.96	2,697,915.75	2,908,702.60
Total Liabilities and Capital	$7,003,917.83	$7,240,879.10	$7,624,693.11	$7,858,778.29	$7,880,412.59	$8,271,879.53

Summary of Reserves	1945	1946	1947	1948	1949	1950
Reserve for accrued interest (Bond Issue)	$ 652,133.29	$ 689,063.29	$ 725,993.29	$ 762,923.29	$ 799,853.29	$ 836,783.29
Reserve for Contract Bonds	250,000.00	250,000.00	250,000.00	250,000.00	250,000.00	250,000.00
Reserve for Workmen's Compensation Insurance	150,000.00	150,000.00	150,000.00	200,000.00	200,000.00	200,000.00
Reserve for public liability	100,000.00	100,000.00	100,000.00	200,000.00	200,000.00	200,000.00
Reserve for fire and tornado insurance	250,000.00	250,000.00	250,000.00	250,000.00	250,000.00	250,000.00
Reserve for sand & gravel replacement	100,000.00	100,000.00	100,000.00	100,000.00	100,000.00	100,000.00
Reserve for purchase of concrete mixing equipment	500,000.00	500,000.00	500,000.00	500,000.00	500,000.00	500,000.00
Reserve for 1941 income taxes	3,974.55	3,974.55	3,974.55	3,974.55	3,974.55	.....
Reserve for Columbia Company good will	293,521.65	293,521.65	293,521.65	293,521.65	293,521.65	293,521.65
Reserve for 1942 income taxes	16,663.61	16,663.61	16,663.61	16,663.61	.....	.....
Reserve for new Southeast plant	500,000.00	500,000.00	500,000.00	500,000.00	500,000.00	500,000.00
Reserve for post war rehabilitation	1,333,000.00	1,333,000.00	1,333,000.00	1,333,000.00	1,333,000.00	1,333,000.00
Reserve for excess profits tax, post war credit	26,134.21	26,134.21	26,134.21	26,134.21	26,134.21	.....
Reserve for D. C. income tax 1945	10,333.75	.....	.....	.....	.....	.....
Reserve for Federal income tax 1945	112,967.19	.....	.....	.....	.....	.....
Reserve for D. C. income tax 1946	.....	11,745.36	.....	.....	.....	.....
Reserve for Federal income tax 1946	.....	122,981.72	.....	.....	.....	.....
Reserve for D. C. income tax 1947	.....	.....	18,977.52	.....	.....	.....
Reserve for Federal income tax 1947	.....	.....	196,301.59	.....	.....	.....
Reserve for D. C. income tax 1948	.....	.....	.....	16,456.17	.....	.....
Reserve for Federal income tax 1948	.....	.....	.....	171,058.63	.....	.....
Reserve for D. C. income tax current yr.	.....	.....	.....	.....	10,536.08	19,608.22
Reserve for Federal income tax current yr.	.....	.....	.....	.....	99,646.60	255,190.16
Total	$4,298,728.25	$4,347,084.39	$4,464,566.42	$4,623,732.11	$4,566,666.38	$4,738,103.32

UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

No. 7886.

THE SMOOT SAND & GRAVEL CORPORATION, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

ON PETITION TO REVIEW THE DECISIONS OF THE TAX COURT OF THE UNITED STATES.

This cause came on to be heard on the record from the Tax Court of the United States, and was argued by counsel.

On consideration whereof, It is now here ordered and adjudged by this Court that the decisions of the said Tax Court of the United States, in this cause, be, and the same are hereby, affirmed.

January 11, 1960.

SIMON E. SOBELOFF
Chief Judge, Fourth Circuit

A true copy,

Teste:

RICHARD M. F. WILLIAMS, JR., *Clerk*,
U.S. Court of Appeals for the Fourth Circuit.

By MARGARET L. DAVIS,
Deputy Clerk.

UNITED STATES COURT OF APPEALS
FOR THE FOURTH CIRCUIT

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THE SMOOT SAND & GRAVEL CORPORATION, *Petitioner*,

v.

COMMISSIONER OF INTERNAL REVENUE, *Respondent*.

Order

Upon consideration of the petition for rehearing and the brief in support thereof, the petition is hereby denied.

SIMON E. SOBELOFF
Chief Judge, Fourth Circuit
MORRIS A. SOPER
United States Circuit Judge
HERBERT S. BOREMAN
United States Circuit Judge

FILED
Feb 24 1960
R. M. F. WILLIAMS, JR.
Clerk

A true copy,

Teste:

RICHARD M. F. WILLIAMS, JR., *Clerk*,
U.S. Court of Appeals for the Fourth Circuit

By MARGARET L. DAVIS,
Deputy Clerk.

Statutes, Regulations and Senate Finance Committee Report Involved

Applicable provisions of the Internal Revenue Code of 1939 and Regulations are as follows:

"SEC. 102. SURTAX ON CORPORATIONS IMPROPERLY ACCUMULATING SURPLUS.

"(a) Imposition of Tax.—There shall be levied, collected, and paid for each taxable year (in addition to other taxes imposed by this chapter) upon the net income of every corporation (other than a personal holding company as defined in section 501 or a foreign personal holding company as defined in Supplement P) if such corporation, however, created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders or the shareholders of any other corporation, through the medium of permitting earnings or profits to accumulate instead of being divided or distributed, a surtax equal to the sum of the following:

"27½ per centum of the amount of the undistributed section 102 net income not in excess of $100,000, plus

"38½ per centum of the undistributed section 102 net income in excess of $100,000.

* * * * *

"(c) Evidence Determinative of Purpose.—The fact that the earnings or profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid surtax upon shareholders unless the corporation by the clear preponderance of the evidence shall prove to the contrary."

Regulations 111—Sec. 29.102-1. Taxation of corporation formed or utilized for avoidance of surtax.—

"Section 102 imposes (in addition to other taxes imposed by chapter 1) a graduate income tax or surtax upon any domestic or foreign corporation formed or availed of to avoid the imposition of the individual surtax upon its shareholders or the shareholders of any other corporation through the medium of permitting earnings or profits to accumulate instead of dividing or distributing them. • • •

Sec. 29.102-3. Unreasonable accumulation of profits.—

"An accumulation of earnings or profits (including the undistributed earnings or profits of prior years) is unreasonable if it is not required for the purposes of the business, considering all the circumstances of the case. It is not intended, however, to prevent accumulations of surplus for the reasonable needs of the business if the purpose is not to prevent the imposition of the surtax. No attempt is here made to enumerate all the ways in which earnings or profits of a corporation may be accumulated for the reasonable needs of the business. Undistributed income is properly accumulated if retained for working capital needed by the business; or if invested in additions to plant reasonably required by the business; or if in accordance with contract obligations placed to the credit of a sinking fund for the purpose of retiring bonds issued by the corporation. The nature of the investment of the business, the financial condition of the corporation at the close of the taxable year, and the use of the undistributed earnings or profits will be considered in determining the reasonableness of the accumulations.

"The business of a corporation is not merely that which it has previously carried on, but includes in gen-

eral any line of business which it may undertake. However, a radical change of business when a considerable surplus has been accumulated may afford evidence of a purpose to avoid the surtax. * * * "

Applicable provisions of the Internal Revenue Code of 1954, as amended, together with explanatory annotations by Prentice-Hall, are as follows:

"SEC. 534. BURDEN OF PROOF.

"(a) General Rule.—In any proceeding before the Tax Court involving a notice of deficiency based in whole or in part on the allegation that all or any part of the earnings and profits have been permitted to accumulate beyond the reasonable needs of the business, the burden of proof with respect to such allegation shall—

"(1) if notification has not been sent in accordance with subsection (b), be on the Secretary or his delegate, or

"(2) if the taxpayer has submitted the statement described in subsection (c), be on the Secretary or his delegate with respect to the grounds set forth in such statement in accordance with the provisions of such subsection.

"(b) Notification by Secretary.—Before mailing the notice of deficiency referred to in subsection (a), the Secretary or his delegate may send by registered mail a notification informing the taxpayer that the proposed notice of deficiency includes an amount with respect to the accumulated earnings tax imposed by section 531. In the case of a notice of deficiency to which subsection (c)(2) applies and which is mailed on or before the 30th day after the date of the enactment of this sentence, the notification referred to in the preceding sentence may be mailed at any time on or before such 30th day."

"Amendment.—Sec. 534 (b) appears above as amended by Sec. 5 of Public Law 367, Aug. 11, 1955, which added the sentence beginning with 'In the case'.

"(c) Statement by Taxpayer.—Within such time (but not less than 30 days) after the mailing of the notification described in subsection (b) as the Secretary or his delegate may prescribe by regulations, the taxpayer may submit a statement of the grounds (together with facts sufficient to show the basis thereof) on which the taxpayer relies to establish that all or any part of the earnings and profits have not been permitted to accumulate beyond the reasonable needs of the business.

• • • •

"(e) Application of Section.—

"(1) Notwithstanding any other provision of law, this section shall apply with respect to taxable years to which this subchapter applies and (except as provided in paragraph (2)) to taxable years to which the corresponding provisions of prior revenue laws apply.

"(2) In the case of a notice of deficiency for a taxable year to which this subchapter does not apply, this section shall apply only in the case of proceedings tried on the merits after the date of the enactment of this paragraph.

"Amendment.—Sec. 534(e) appears above as amended by Sec. 4 of Public Law 367, Aug. 11, 1955, which struck out the following:

"(e) Effective Date.—This section shall apply only with respect to a notice of deficiency for a taxable year to which this subchapter applies which is mailed more than 90 days after the date of enactment of this title.' "

Applicable statements in the Senate Finance Committee Report are as follows (1958 P-H, Volume 1, pp. 4737-4738):

"The technical amendments made by your committee make clear that the shift in the burden of proof under section 534 applies where the issue between the Government and the taxpayer relates to the portion of the earnings and profits which may be accumulated during the taxable year for the reasonable needs of the business. Under the amendment made by your committee to section 535(c), the portion of the earnings and profits for the taxable year which are retained for the reasonable needs of the business is not subject to the accumulated earnings tax. (Senate Committee Report—Detailed Discussion).

"Section 4 of this bill amends the Internal Revenue Code of 1954 to provide that the burden of proof in certain cases involving the accumulated-earnings tax will be on the Government rather than the taxpayer. Under this provision, the burden will be on the Government in cases involving taxable years to which the Internal Revenue Code of 1939 applies in the case of proceedings tried on the merits after the date of enactment of this bill if the burden of proof would have been on the Government had the deficiency been such that section 534 of the 1954 Code (as originally enacted) applied.

"The relief that this provision will grant to taxpayers can be shown by comparison of the provisions for burden of proof under the 1939 Code as compared with the 1954 Code. Under the 1939 law if the Commissioner of Internal Revenue proposed a deficiency on the ground that the taxpayer has accumulated earnings and profits in excess of the reasonable needs of the business, the taxpayer had the burden of proof as to the reasonableness of the accumulation. If earnings and profits were accumulated in excess of the

reasonable needs of the business, the accumulation was deemed to be for the purpose of tax avoidance unless the taxpayer proved otherwise by the clear preponderance of the evidence.

"Under the 1954 Code the taxpayer may, upon receipt of notice of a proposed deficiency with respect to the accumulated earnings tax, file a statement of the grounds (together with sufficient facts to show the basis of the statement) on which the taxpayer relies to establish the reasonableness of the accumulation. If the taxpayer submits such a statement within the proper time, the burden of proof will be upon the Government as to whether the accumulation is in excess of the reasonable needs of the business. If the taxpayer does not file such a statement, it must bear the burden of proof as under prior law. Moreover, if the taxpayer's statement of the grounds relied upon fails to set forth the facts which show the basis thereof, the burden of proof with respect to these grounds must be borne by the taxpayer. If the Secretary or his delegate fails to give the taxpayer notification prior to the issuance of a notice of deficiency, then the Government must bear the burden of proof even though the taxpayer has filed no statement.

"The amendment made to section 534 of the 1954 Code by sections 4 and 5 of this bill will apply the provisions of the 1954 Code to all cases in which the proceedings are tried on the merits after the date of enactment of this bill [August 11, 1955]."

Applicable provisions of the Regulations promulgated May 12, 1959, under the August 11, 1955 amendment placing the burden of proof upon respondent are set forth in paragraphs 4754-B and 4754-D of the 1959 Prentice-Hall Federal Tax Service, as follows:

"Reg. (TD 6377, filed 5-12-59.) § 1.534-2. *Burden of proof as to unreasonable accumulations in cases*

before the Tax Court—(a) *Burden of proof on Commissioner.* Under the general rule provided in section 534(a), in any proceeding before the Tax Court involving a notice of deficiency based in whole or in part on the allegation that all or any part of the earnings and profits have been permitted to accumulate beyond the reasonable needs of the business, the burden of proof with respect to such allegation is upon the Commissioner if—

"(1) A notification, as provided for in section 534(b) and paragraph (c) of this section, has not been sent to the taxpayer; • • •

"Reg. (TD 6377, filed 5-12-59.) § 1.534-4. *Taxable years subject to the Internal Revenue Code of 1939.* The rules prescribed in §§ 1.534-1 to 1.534-3, inclusive, apply in any proceeding tried on the merits after August 11, 1955, before the Tax Court and involving a notice of deficiency in surtax imposed by section 102 of the Internal Revenue Code of 1939, for a taxable year subject to such Code, based in whole or in part on the allegation that all or any part of the earnings and profits of the taxpayer have been permitted to accumulate beyond the reasonable needs of the business. If a notice of deficiency for a taxable year described in the preceding sentence was mailed before September 11, 1955, a notification mailed before that date shall be effective as fully as though such notification had been mailed before the notice of deficiency was mailed."